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Newsletter

Finance & Insolvency

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In the second of our newsletters this August, we focus on Fintech, Green Loan and Sustainability Linked Loan Principles, Climate Risk Practices in the banking industry and Cryptocurrencies

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The Hong Kong Institute of Monetary and Financial Research (HKIMR)'s paper on the adoption and innovation of Fintech in the banking industry

Simon Deane and Natalie Chan

The Hong Kong Institute for Monetary and Financial Research (HKIMR) conducted a survey in July 2019 to study the impact of Fintech innovations in Hong Kong's banking industry. The report, published in May 2020, summarises the status of Fintech adoption by incumbent banks and recently licensed virtual banks (collectively "**Banks**"), as well as their outlook for the future prospects of Fintech development. A key finding was that, on average, 86% of Banks reported wide adoption of Fintech in their businesses, with the most common motivations being customer retention, increasing customer base and improving efficiency. Banks appear to view Fintech more as an opportunity than a threat and are confident that it will continue to play a key role over the next 10 years.

To help the banking industry understand the challenges and potential of Fintech, the report provides an overview of the initiatives introduced by the HKMA to address Fintech-related issues. It also offers insights into how Banks have engaged in Fintech innovations, pointing out that most Banks see themselves as proactive or reactive adopters rather than passive followers in applying Fintech.

The report is the first in a series of research reports published under the Applied Research Programme of the HKIMR. The full report can be accessed here.

APLMA/LMA/LSTA joint guidance papers on Green Loan principles and Sustainability Linked Loan principles

Simon Deane and Natalie Chan

In May 2020, the Asia Pacific Loan Market Association (APLMA), the Loan Market Association (LMA) and the Loan Syndications and Trading Association (LSTA) jointly published two guidance papers on green loan principles and sustainability linked loan principles, seeking to address some of the most frequently asked questions about green loans and sustainability linked loans (SLLs).

Green Loans

A green loan is defined as any type of facility made available to a borrower to finance or re-finance Green Projects and must align with the following four core components:

- **use of proceeds** – loan proceeds should be used for Green Projects only; for a non-exhaustive list of Green Projects, please see Appendix 1 to the Green Loan Principles;
- **process for project evaluation and selection** – borrowers should clearly communicate their environmental sustainability objectives to their lenders;
- **management of proceeds** – the proceeds of a green loan should be transparent and easy to track (e.g. by using a separate account for green proceeds); and
- **reporting** – lenders should obtain up-to-date information on the use of proceeds from borrowers annually until the loan is fully drawn.

Due to the varied nature of the green loan market, currently there is no template wording available for adoption in the loan documentation process. Important clauses such as the purpose or use of proceeds provisions, information undertakings and representations should be given due consideration when drafting green loans. Whilst there is no established market standard as to what amounts to a "green" breach, parties should consider whether such a breach will trigger event of default and cross-default provisions across outstanding loans.

For the complete APLMA/LMA/LSTA Guidance on Green Loan Principles, please see here.

Sustainability linked loans

An SLL is any type of facility which incentivises the borrower's achievement of ambitious, predetermined sustainability performance objectives. The fundamental difference between green loans and SLLs is the utilisation of loan proceeds – whilst the proceeds of green loans must be used for Green Projects only, the proceeds of SLLs can be used for general corporate purposes. SLLs seek to improve the borrower's sustainability profile by aligning loan terms to the borrower's performance against the relevant predetermined sustainability performance targets (SPTs). If the predetermined SPTs are met, borrowers may benefit from a reduced interest rate, depending on the relevant loan terms.

The SLL Principles have four core components:

- **relationship to borrower's overall sustainability strategy** – borrowers of SLLs should clearly communicate to their lenders their sustainability objectives and how these align with their proposed SPTs;
- **target setting – measuring the borrower's sustainability—**SPTs should be ambitious and meaningful to the borrower's business; it should be tied to a sustainability improvement in relation to a predetermined performance target benchmark;
- **reporting** – borrowers should keep their lenders informed of their up-to-date SPTs, together with any underlying methodology and assumptions, at least once per annum; and
- **review** – for loans where information relating to SPTs is not made publicly available, external review of a borrower's performance against its SPTs is strongly recommended.

For the complete APLMA/LMA/LSTA Guidance on SLL Principles, please see here.

The Hong Kong Money Authority (HKMA)'s Guidance for banks on Climate Risk Practices

Simon Deane and Bonnie Wong

The Hong Kong Money Authority (HKMA) published a White Paper on 30 June 2020 to set out its recommendations and supervisory expectations on green and sustainable banking around four areas: governance, strategy, risk management and disclosure. The HKMA advised AIs which are subsidiaries of international banks to assess relevance of any parent bank's climate policy in the context of its Hong Kong operations and ensure that local specialties are addressed.

In formulating these recommendations, the HKMA has recently consulted selected AIs about their approach to climate risk management in the four areas. Some of the key measures adopted by these AIs are noted and have been used as practical guidance in the White Paper (see HKMA circular dated 7 July 2020 and Annex).

Below is an overview of the recommendations set out by the HKMA:

I. Governance: Board's accountability in climate resilience and oversight of climate strategy development and implementation

The HKMA noted that the most advanced AIs have:

- assigned accountability to the board of directors and senior management for oversight of the management of climate risks and implementation of risk management frameworks respectively, while tasking existing committees or individuals to consider climate change risks and possible remedies

- embedded climate-related risks into an overall climate risk appetite framework, with some receiving regular updates on project progress to facilitate their oversight

- to track performance, set target positions for sustainable financing in an external sustainability ranking, with performance reviewed annually and evaluated against senior management.

II. Strategy: AIs should embed climate considerations throughout the strategy formulation process, while organisational structures, business policies, processes and resources availability should be reviewed and enhanced to ensure effective strategy implementation.

The HKMA noted that advanced AIs have adopted 3 board initiatives:

- made changes to organisational structure, with several AIs having created a dedicated unit for climate risks consulting and cross-functional working groups to support the AIs' climate agenda. A three-lines-of-defence structure, involving (1) business teams, (2) risk departments and (3) audit, was also set up with each line scrutinizing and challenging climate risk profiles created by the previous line

- conducted reviews to ensure adequate resources for managing climate risks

- adopted a top-down approach to raise staff awareness, including specialist training on climate change, external and internal communication (e.g. international conferences and circulation of featured articles) and recruitment of environmental experts.

III. Risk Management: AIs are expected to incorporate climate risk considerations into their existing risk management framework.

The HKMA noted that advanced AIs have:

- conducted holistic reviews to identify their exposures at portfolio level, client level (and operational level)

- conducted scenarios analysis including climate change scenarios, sector level assessments and customer level assessment (assessing potential financial impact at customer level)

- adopted multiple metrics (e.g. carbon-related assets as a percentage of total banking products) across their portfolios to monitor exposure including climate vulnerability assessments for clients. Based on risk

identification, these AIs are establishing internal concentration limits or have excluded sectors and projects highly sensitive to climate change.

IV. **Disclosure: AIs should develop an approach to disclosing climate-related information to enhance transparency, taking the Task Force on Climate-related Financial Disclosures (TCFD) recommendations as the core reference.**

The HKMA noted that advanced AIs aimed to develop a voluntary, consistent climate-related financial risk disclosure framework for firms to report information to stakeholders—some AIs have even included climate-related disclosures in their annual reports. Through disclosures, AIs can help stakeholders make informed decisions and improve climate risk management in the banking industry.

Please refer to the White Paper for more information regarding the above recommendations.

The Global Financial Markets Association's (GFMA) comments on challenges raised by "Global Stablecoin" Arrangements

Simon Deane and Bonnie Wong

The GFMA recently provided its response to the Financial Stability Board's ("FSB") consultation paper ("the Paper") titled *Addressing The Regulatory, Supervisory And Oversight Challenges Raised By "Global Stablecoin" Arrangements*. The GFMA put forward certain recommendations to support the implementation of global stablecoin ("GSC") arrangements provided for in the Paper. These recommendations include:

- FSB should utilise a crypto-asset taxonomy that clearly establishes "stablecoin" as a subcategory of "value stable crypto-assets" to facilitate appropriate regulatory treatment.
- Principle of 'same activity, same risk, same regulation' should be applied to the regulation of stablecoin for effective supervision and oversight, excluding digital money already regulated under existing rules or subject to Financial Market Infrastructure ("FMI") regulation.
- FSB should clarify to whom the Paper is directed (issuers, custodians etc?) and also consider other service providers which interact with stablecoin arrangements.
- FSB should continue its global coordination with other regulators as international consistency is important, to provide clarity around jurisdictional oversight and to encourage the development of global standards and principles for interoperability.
- Regulatory framework adopted by the FSB must be technology agnostic to remain agile and encourage innovation.
- GFMA requested FSB to provide further details about what constitutes "global" or "systematic" importance and their associated regulatory requirements, and to distinguish between "stablecoin arrangements" and "systemically important stablecoin arrangements" focusing on the operator of the system rather than the stablecoin itself.

The GFMA felt that the existing FSB definition of a stablecoin is too broad, and suggested a new definition[1] which excludes other digital forms of money already covered by existing regulations. It also acknowledged that stablecoin are not only asset-linked or algorithm-based, but can be hybrid. Thus, the FSB should consider how hybrid stablecoins should be regulated.

The GFMA's other comments included the following:

- Consideration of whether regulations for GSC arrangements should also include other service providers as systemically/globally important.

[1] *"Tokens (crypto-assets) designed to minimise/eliminate price fluctuations relative or in reference to other asset(s), which are not issued by a central bank, FMI, bank, credit institution or highly-regulated depository institution. They may represent a claim on the issuing entity, if any, and/or the underlying assets."*

- Financial stability concerns for financial institutions in the case of operational failure of a GSC arrangement particularly where the GSC arrangement is highly complex.
- Employ safeguards where stablecoins are linked to fiat currency and issued by an institution that is not a regulated credit institution.

As the asset management function of a stablecoin arrangement may fall outside existing regulations and create a regulatory gap, regulators should determine who should be held responsible for overall governance of the arrangement and whether this responsibility could shift based on the decentralised nature of the issuer or stability mechanisms. All in all, the GFMA endorsed the FSB's recommendations and recommended that institutions conducting the same activities using Distributed Ledger Technology be subject to the same regulatory requirements or oversight.

Please see the full GFMA response here.

The Financial Action Task Force (FATF)'s reports on risks of virtual assets

Simon Deane and James Tong

The Financial Action Task Force (FATF) recently published a report on its 12-month review of the Revised FATF Standards on Virtual Assets and Virtual Asset Service Providers, and a report on so-called stablecoins which highlighted associated risks of money laundering/terrorism financing ("ML/TF"). FATF concluded that there may be ML/TF risks associated with the stabilisation mechanism specific to stablecoin, and identified three particular ML/TF vulnerabilities (some of which may overlap with those for virtual assets in general):

- **Anonymity:** The revised FATF Standards published in June 2019 ("revised FATF Standards") impose requirements to address risks posed by anonymity by placing anti-money laundering and counter financing of terrorism ("AML/CFT") obligations on entities carrying out financial activities involving virtual assets, such as virtual asset service providers ("VASPs"). These require VASPs to identify their customers and maintain transaction records. However, it was noted that such controls can be avoided by using peer-to-peer transactions without the use of a regulated intermediary.
- **Global Reach:** Although virtual assets may not currently be widely used for cross-border payments, partly because of their unstable value, stablecoin address the volatility issue and purport to be a faster and cheaper means of cross-border transfer. Thus, the potential global reach of stablecoin heightens ML/TF risks as they often rely on infrastructure spread across several jurisdictions to transfer funds or execute payments; this segmentation of services means that the responsibility for AML/CFT compliance and enforcement may be unclear.
- **Layering:** The use of 'chain-hopping' (quick exchanges between different virtual assets) allows the multiple layering of illicit funds within a short timeframe, allowing money laundering networks to disguise the origins of funds and launder illicit proceeds.

Generally speaking, the ML/TF risks depend on liquidity and exchangeability of stablecoin. Although virtual assets generally give rise to price volatility, complexity, and trust and security concerns meaning they are not widely used, stablecoin can overcome some of these concerns making them easier to use and potentially ready for mass-adoption. To mitigate stablecoin ML/TF risk, strong international co-operation is vital, focusing on information-sharing and co-ordinated supervisory and law enforcement action. The FATF recognised three further residual risks:

- Unregulated anonymous peer-to-peer transactions via unhosted wallets.
- Exploitation of weak or non-existent AML/CFT regulations in some jurisdictions to evade supervision and enforcement. FATF thus proposes an enhanced monitoring process for jurisdictions identified as having strategic AML/CFT deficiencies.
- Stablecoin that, once launched and self-functional, would immediately dissolve the central body that created them. Decentralisation would necessitate exercise of supervisory powers **before** the stablecoin launch to ensure that AML/CFT protections are built in before release.

For general virtual assets, anonymous peer-to-peer transfers pose severe ML/TF risks as they are not explicitly subject to AML/CFT obligations under the revised FATF standards. FATF recommended that national authorities consider appropriate mitigation measures, such as banning or refusing to license platforms allowing unhosted wallet transfers and introducing transactional or volume limits on the platforms. The revised FATF Standards also introduce the "Travel Rule", which requires VASPs to obtain, hold and exchange information about originators and beneficiaries of virtual asset transfers. Besides anonymity, FATF also identified certain other main trends of virtual asset ML/TF risks, including:

- VASPs registered/operating in jurisdictions with weak AML/CFT regulations, and the use of multiple VASPs (domestic and/or international) allowing more time for criminals to move criminal proceeds.
- Increased anonymity of transactions by methods such as registering internet domain names, using atomic swapping exchanges and "dusting".
- With the ongoing COVID-19 pandemic, increased use of virtual assets to move and conceal illicit funds such as laundering proceeds earned from selling COVID-19 medicine.

To continue mitigating the ML/TF risks of virtual assets, FATF will:

- request its members and the global network to implement the revised FATF Standards as a matter of priority, including building AML/CFT controls into regulatory regimes for stablecoin, urging the G20 to lead by example;
- continue to monitor ML/TF risks posed by virtual assets and stablecoin and consider whether further action is necessary;
- provide tailored, risk-based approach advice for AML/CFT regulation of stablecoin and address practical issues as part of a broader update of FATF's Guidance on virtual assets; and
- work to enhance the international framework for VASP supervision, particularly relating to information-sharing between supervisors and capability building amongst authorities designated to oversee VASPs' compliance with AML/CFT requirements.

Want to know more?

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